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The New BRICS Bank: Challenging the International Financial Order?

On 15th July 2014 the BRICS Group members (Brazil, India, China, Russia and South Africa) signed agreements that established two new international financial institutions, the New Development Bank (NDB) and the Contingency Reserve Arrangement (CRA).[1] The NDB with an initial capital of US\$100bn. has a brief to provide no-strings loans to Emerging Market and Developing Countries (EMDCs), principally for major infrastructure and sustainable development projects. In addition, compared to the established international institutions the NDB is committed to providing loans more rapidly and more cheaply, and operate through more representative and democratic forms of governance and decision making. (see BRICS 2013, paragraph 9; BRICS 2014b). The NDB is complemented by the US\$100bn. CRA, which is intended to provide assistance to countries with short-term liquidity problems (BRICS 2014b paragraph 13; BRICS 2014c). It is expected that both institutions will begin lending in 2016.

Since the establishment of the NDB and the CRA, two new regional financial bodies have also been agreed, both led by China. Firstly, the Asian Infrastructure Investment Bank (AIIB), with an initial capital of US\$100bn., was signed into existence by 21 Asia-Pacific economies on 24 October 2014.[2] Secondly, on 8 November the Silk Road Infrastructure Fund (SRIF) was announced, with an initial Chinese contribution of US\$40bn. and the aim of promoting infrastructure and linkages within Central and Southern Asia (Carsten and Blanchard 2014).

Behind all these new institutions lies a significant gap in the institu-

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tional and funding provision for EMDCs, not least in Asia, and related major dissatisfaction with the priorities, procedures, and governance of the ADB, IMF and World Bank, and the conditionalities they attach to loans. Despite this, the BRICS have been at pains to stress that the NDB and CRA are intended to complement rather than replace the established financial order, a point also stressed by China with respect to the AIIB and SRIF (BRICS 2014a paragraph 11; *People's Daily Online* 2014). However, whether one accepts this or not, the founding of these new agencies must be seen as an implicit challenge to the established international financial system. A challenge that has to be evaluated in terms of the prospect of the new institutions being able to function effectively, expand their membership and develop lending capacity, and a series of other developments that are pressing on the international financial order and, indeed, the form of the global system as a whole.

While it can be argued that the proposed initial financial capacities of the new institutions are limited compared to the IMF's US\$750bn. liquidity, the World Bank's lending capacity of US\$200bn.[3] and ADB's US\$165bn.,[4] it should be stressed that behind the NDB and CRA lie the foreign reserves of the BRICS (some US\$5tr.), while in 2013 the international lending of the Brazilian Development Bank (BNDES) was US\$88bn. [5] and that of the Chinese Export Import Bank's US\$240bn.[6] A more serious barrier to effective operation could be the disparate and often far from harmonious nature of the BRICS group (see for example Nye 2013). Undoubtedly, there are major differences (and lack of trust), which reduces the group's effectiveness and necessitate often protracted negotiations. However, while the process of agreeing the NDB stretched over two years and revealed many serious differences between the BRICS that involved much compromise,[7] the critical point is that agreement

was reached, as it was with respect to the CRA and the many other initiatives that have come out of the BRICS summits (see below). That is, these countries do have some have significant overlapping interests, and are capable of highly pragmatic decision-making (Xianoyum and Carey 2014). However, it must be stressed that the decision-making capacity and unity of the BRICS (and the members of the AIIB) are likely to be severely tested in setting up the new institutions. For quite apart from any opposition that they might experience from the old institutions and their principle backers (see below), the agreements that have been signed are far from detailed blueprints and much planning and negotiation remains to be done. Notably, with respect to the NDB and CRA, there are significant issues over the mechanism for extending the membership beyond the BRICS and the implications of this for institutional governance. The stated intention is for all members of the CRA and NDB to have an equal vote (with no provision for a veto), individual countries only able increase their contribution with the majority agreement of the others and limits to the extent to which one member can dominate the funding.[8] However, it is not clear how this will operate as membership expands, not least given the stipulation that expansion must not reduce the BRICS share of capital below 55% (*EuroActi* 2014), and the extent to which financial resources are concentrated in Chinese hands. Though, it should be stressed that significant efforts have been made to offset the perception that China will dominate the institutions. For the NDB, while the headquarters of the will be in Shanghai, during the first five years the President will be an Indian, the Chairman of the Board of Governors Russian, the Chairman of the Board of Directors Brazilian, and the first regional centre of the Bank will be in South African (BRICS 2014 paragraph 12). Of course it can be argued that this move will prove to be little more than window dressing, with the interests of the BRICS in general and

China in particular coming to over-ride those of the other members.[9] This could result in a lending regime that is no more developmental than those of the established institutions. A situation that could well produce tensions and discontents would undermine the effectiveness and legitimacy of the new institutions. Thus, for all of the new institutions the lending regime and level of transparency, and how these are perceived, will be critical to success.

Details of the lending procedures are as yet scant, while the assumption is that the new institutions will follow the lead of the NDB which has stressed that loans will be 'string free', this leaves the intriguing question of what this means in practice. While all the BRICS statements have made it clear that the concern of the NDB will be with 'projects not policies' and there will be none of the interference with domestic affairs or the ability of governments to formulate and implement policies that characterise lending by the IMF and World Bank, this does not mean that in other respects the loan conditions would be less onerous. For the NDB, particularly in its early stages, will have to prioritise high quality loans in order to maximise the development impact and minimise the risk of default. This is not least because it will affect the credit rating, the cost of NDB borrowing and the generation of profit levels necessary to support future lending (Griffith-Jones (2014: 8). Such considerations could well seriously constrain lending, particularly to poorer countries and for more developmental projects, thus adding to the possibility for tensions and discontent amongst would-be borrowers noted above. When this is combined with a commitment to process loans rapidly, in a less bureaucratic manner, while keeping the cost below that of the World Bank, which is able to borrow at exceptionally low rates,[10] much is going to be asked of the technical, administrative, managerial, diplomatic and public relations capacity of the NDB.[11]

While the sheer scale of the task of

setting up the new institutions from scratch should not be underestimated (*The Economist* 2014), nor should the discontent with the operation of governance of the IMF and World Bank, and the scale of gap in funding provision for the EMDCs. There are several interlinked issues here. Firstly, the failure to reform the global financial architecture, which has left the World Bank and, even more, the IMF dominated by Western interests. Thus, the BRICS (and the EMDCs as a whole) perceive themselves as having little input into policy formulation and implementation in these key institutions.[12] A point made very clearly in the 'Sixth BRICS Summit Fortaleza Declaration' that followed the signing of the NDB agreement.[13] Secondly, in the EMDCs the level of discontent with the lending practices and conditionalities of the World Bank and IMF are such that for many governments these are toxic brands that should be avoided at all costs (see comments below on South Korea). This reflects the whole history of SAPs (Structural Adjustment Programmes) and bailout programmes, with their imposition of austerity, budget cuts and neo-liberal agendas, increasingly accompanied by political, social and environmental requirements. While much in the neoliberal agenda has long been criticised, since 2007 it has become significantly discredited. This not least because of the failure of Western countries to adhere to the advice give so freely to the EMDCs, for example with respect to debt and fiscal deficits, and the manner in which the post-2007 crisis was rooted in forms of regulation, practice and innovation in the Western financial sectors, that the EMDCs and been told to emulate. Thus, increasing numbers of countries have been reluctant to accept either the conditionalities or the advice of the World Bank and, even more, the IMF. In addition, there is widespread belief that countries are excluded from funding on ideological or political grounds at the behest of, in particular, the USA. Thirdly, even if countries are eligible for loans and pre-

pared to accept the conditions, there is simply not enough funding available. The shortage is particularly acute for infrastructure projects, with an estimated annual shortfall of some US\$1tri.,^[14] though ADB has suggested that for Asia-Pacific alone there is a need for US\$8tr. of such investment by 2020 (Page 2014: 10). The inability of the World Bank and its regional subsidiaries to provide the necessary infrastructure investment for EMDCs has led to increased reliance by governments on foreign private sector sources, increasingly utilizing comparatively high cost variations on PPP. Indeed, the view that infrastructure funding is now the province of private investors seems to have permeated both the major Western donors, as underlined at the November 2014 G20 Summit (Elliot 2014), and the international agencies which have promoted the establishment of institutions to channel such investment, as in the case of African Development Bank's Africa50.^[15] However, despite such initiatives, and the level of need, private sector funding has become less available for infrastructure projects in the EMDCs (Griffith-Jones 2014: 6).

The shortage of funds for infrastructure projects poses particular problems for the BRICS. In Brazil and Russia growth continues to be being driven by resource exports, with consequent need for heavy infrastructure investment, while China and India are increasingly depended on imported resources and the ability of, in particular, other EMDCs to construct the facilities necessary to maintain and expand output. It could of course be argued that China, and, to a lesser extent, India, could achieve much of their need to secure resource supplies and markets in developing economies through bilateral lending. However, channelling the funding through multilateral agencies enables risk to be pooled, limits reputational costs, and increases the perceived legitimacy.

Thus, it can be argued that new institutions with a strong emphasis on funding

infrastructure for EMDCs and a different approach to lending and institutional governance would fill a major gap in the international financial architecture. A strong argument can also be made with respect to short-term liquidity funding and the importance of the CRA as an alternative to the IMF (Griffith-Jones 2014: 2). Here, however, the issue is not so much a shortage of funds, but rather the extreme reluctance of very many countries to submit to the Fund's conditionalities noted above. This reluctance is well illustrated by the response of the governments of Indonesia and South Korea to the liquidity crises that they experienced during the latter part of 2008. Crises that resulted from the rapid liquidising of assets in emergent markets that created a major shortage of US dollars (Sussangkarn 2010a: 13). Neither the Indonesian nor South Korean governments were prepared to apply to the IMF for assistance. Indeed, in the case of South Korea, it was believed that the strength of popular feeling against the IMF was such that the government could not survive an approach to the Fund (Kawai 2009: 8; Sussangan 2010b). In the event, South Korea was assisted by the Federal Reserve, a reflection of its continuing key role in the USA security strategy in East Asia. In contrast, the Fed refused funding to Indonesia which was viewed less favourably by the USA, not least because of what was regarded as less than wholesale support for the American-led Global War on Terror (GWOT) and related actions in Afghanistan and the Middle East. Significantly, Indonesia was able to obtain the necessary funds through currency swaps with the Bank of China and the Bank of Japan, which served to focus attention on the development of such arrangements and related regional institutional structures noted below (Dixon 2010: 5). More broadly, the experience of the EMDCs since 2007, and the ongoing instability of the global economy, have continued to focuses attention of policy makers in these

countries on the need for alternative funding sources that are in tune with their requirements, and effective and less-Western-centred forms of international financial regulation. [16] In the absence of these, a major crisis, perhaps sparked by the complete unwinding of the USA's Quantitative Easing (QE) programme and subsequent interest rate rises, could force many countries to resort to World Bank and IMF funding, with all the attached unpalatable, if not unsound, policy strings.

It could be that the establishment, and even more, the successful operation of the new institutions will act as the necessary catalyst for reform of the IMF, World Bank and broader international financial architecture (Griffiths-Jones 2014: 15). However, given the lack of progress to date and the refusal of the US Congress to ratify the 2010 agreement on IMF reform, it is doubtful whether changes sufficient to address the demands of the EMDCs are likely to take place rapidly. Rather, the concern is that there will be significant opposition and / or counter moves by the old institutions and their backers, particularly the USA. Though, at the time of writing these has not gone beyond the USA attempting (unsuccessfully) to limit the number of countries signing the AIIB agreement (Page 2014: 11), Japan proposing a major expansion of its infrastructure investment in ASEAN (*Asahi Shimbun* 2014) [17] and ADB announcing a significant increase in lending capacity.[18] In addition, the moves by the USA and Japan, which are the dominant powers within ADB,[19] are perhaps more a reflection of concerns over AIIB becoming a vehicle for China to increase its already considerable regional role, rather than the threat that the new institution poses to the ADB *per se*. [20] As such, the initial response to the AIIB should be seen as very much part of the USA's 'pivot to Asia' policy, which aims to lock countries into US-dominated investment, trade, currency and security structures through a proliferation of bi-lateral agreements and

the overarching Trans-Pacific Partnership (TPP), from which China is excluded. Perhaps more surprising than the limited initial response of the USA to the new institutions was that the NDB was actually welcomed by the President of the World Bank (Jim Yong Kim) as providing much needed additional funding, with an offer to provide technical assistance (*Live Mint* 2014). However, it is unclear what attitude the World Bank would take if the NDB lending does, as appears to be the intention, depart significantly from World Bank lending norms. Similarly, the Director of the IMF (Christine Lagarde) congratulated the BRICS on the CRA and stated that the Fund would like to work with it (Soto 2014). However, this is perhaps not surprising given that the IMF has previously stated a willingness to endorse new funding institutions, but only as long as they are subject to the Fund's scrutiny (Dixon 2012: 3).[21] Thus, both the NDB and CRA could come to face significant opposition from the World Bank, IMF and their principle supporters. Amongst the latter, it would be surprising if the USA did not become an outspoken critic if, as again seems likely, the new institutions begin to lend to regimes that it does not approve of, particularly given existing concerns over Chinese, and to a lesser extent Indian, investment activities in Sub-Saharan Africa. More broadly, there is likely to be some general opposition to the BRICS initiative from commercial and bilateral agencies. Thus, many of the EMDCs could find themselves under political pressure not to participate in the new institutions.

While it is clear that any opposition to the new institutions has to be understood in terms of concerns over the rising powers, particularly China, the challenge implicit in the founding of the AIIB, NDA and CRA must also be seen in the context of other developments that, while also at an early stage, similarly reflect discontent with the Western dominated international financial

architecture centering on the World Bank, the IMF and the use of the US\$. Of particular significance is the proliferation of large-scale currency swaps between central banks – in which China is playing a very major role. Such arrangements are intended to provide short-term liquidity assistance that would more commonly be either obtained from the IMF or, for some favoured countries, the Federal Reserve. In East Asia a network of such swaps has been consolidated into a multilateral fund, the CMIM (Chiang Mai Initiative Multilateralisation) launched in 2010, that some see as a step towards the formation of an Asian Monetary Fund that could directly challenge the position of the IMF in Asia.[22] While behind the CRA proposal there are already formal moves to coordinate economic monitoring and macroeconomic policy, notably with respect to currencies (BRICS 2014, paragraph 13). This is the type of exchange of information, financial monitoring and policy coordination that is rapidly developing in East Asia under the CMIM.[23] For the BRICS the initial focus of such activity on currencies has been driven by depreciations against the US\$, concerns over the impact of the end of QE in the United States, and ongoing discontent with the global role of the US\$ (Griffiths-Jones 2014: 3; see also below).

At the conclusion of the sixth BRICS Summit there was a strongly worded reiteration of discontents over the development a number of other finance related initiatives, notably the Inter-Bank Cooperation Agreement (to promote central bank cooperation), the Exchange Alliance (as a challenge to Western derivatives markets) and the Energy Exchange (as a challenge to the Inter-Continental Exchange; see Cambell 2014). The Sixth BRICS Summit also reiterated discontents over the continued domination of the US\$ and the 'exorbitant privilege' that the USA derives from this (Cambell 2014). While no new initiatives came from this, there are signs of a number of challenges

to the position of the US\$. This centres on shifts towards the use of the Euro, Renminbi and local currencies in both settlements and pricing of key commodities (Dixon (2014). While these shifts remain limited, this could change rapidly given the proliferation of bi-lateral agreements that enable the use of alternatives to the US\$. Particularly notable are the agreements between China and Japan, China and Russia, and Argentina and Brazil. In addition, there are early stage discussions of the development of regional currency regimes in East Asia and Latin America.

All the above developments can be seen as reflecting moves towards the establishment of an alternative international financial order, particularly when seen in the context of the serious damage, dislocation and loss of credibility that the established system has incurred since 2007 and related acceleration of the shifts in the global distribution of economic and political power that were already evident well before the crisis. However, it could be that under present global conditions and the various problems faced by the BRICs (notably the slowing of growth in China, persistent inflation in Brazil and the impact on the Russian economy of the fall in oil prices and Western sanctions), the shifts in the global balance of economic power may significantly slow, while undermining the development of any alternative order and, in particular, stalling the NDB and CRA initiatives. Such a scenario would reduce the immediate challenge to the existing financial order, but would do little to reduce the discontent of the BRICS or the EMDCs as whole. Though it should be stressed that whatever the continuing strength of the challenge, it would seem unlikely (in the absence of some major event) that there will be in any abrupt shift in the international financial system. This a reflection of both the extent of the embedding of the established order and, despite the discontents of the EMDCs over its operation, the manner in which it has provided many of them, not least the BRICS, with

enormous (and continuing) benefits. Thus, the BRICS have no interest in moves that would destabilise the existing international financial order, so the emergence of alternatives and challenges are likely to be gradual. However, much will depend on the reaction of the established order. Some long-overdue accommodation to the reality of the global system could see a comparatively smooth transition to a more diverse, inclusive and responsible system. If this does not happen, the BRICS and the other major emerging economies may be expected to become more assertive. Which may well lead to a far less unified and perhaps less stable international financial system.

Notes

[1] This was the first day of the sixth BRICS summit in Fortaleza, Brazil (see BRICS 2014a paragraphs 11 and 12). The NDB and CRA had been agreed in principle at the Fifth BRICS Summit held in Durban, South Africa (see BRICS 2013a).

[2] This was originally proposed in October 2013 and had been under serious discussion since May 2014.

[3] In 2014 the World Bank announced that it was increasing its lending capacity to US\$300bn., and raising annual lending from US\$15bn. to US\$25bn. (World Bank (2014).

[4] This gives an annual lending capacity of US\$10-11bn.

[5] While the BNDES has been generally extremely successful there are concerns that its lending capacity could be reduced because of budgetary issues in Brazil (see Trevisani 2015).

[6] Griffith-Jones (2014: 1, 9-14) has stressed that the EMCDs, led by the BRICS, represent 25% of global GDP and have savings rates, reserves and investment funds that are more than equal to funding the NDB.

[7] For some comments on the issues that delayed the NDB agreement see EurActiv (2014).

[8] In the NDB each of the five initial members holds 20% of the capital, while for the CRA the contributions are: China US\$41; South Africa US\$5bn.; and Brazil, India and Russia US\$18bn. each.

[9] Concerns that are given some credence by the many commentators that see, in particular, Chinese loans to Sub-Saharan Africa, as reflecting narrow economic inter-

ests – though such views tend to ignore the extent to which most Development Assistance (DA) can be similarly criticised (see for example Bräutigam 2010).

[10] The World Bank is rated AAA, in contrast China is AA and the other BRICS BBB.

[11] This would be even more the case with respect to the CRA, for in evaluating requests for loans to cover liquidity shortages, it would be necessary to undertake some detailed and wide ranging examination of macroeconomic conditions and prospects, as well as government policies.

[12] For an analysis of the extent to which this has been the driving force behind the establishment of the new institutions see SáGuimarães (2014).

[13] ‘We remain disappointed and seriously concerned with the current non-implementation of the 2010 International Monetary Fund (IMF) reforms, which negatively impacts on the IMF’s legitimacy, credibility and effectiveness’ (BRICS 2014c paragraph 18).

[14] See: Bhattachary and Romani (2013); Bhattacharya, Romani and Stern (2012); Griffith-Jones (2014: 2, 5-6).

[15] This aims to provide a \$3bn. infrastructure fund drawn from pension funds, insurance groups, sovereign wealth funds and institutional investors (see Blas 2014).

[16] These concerns were made very clear in the ‘Sixth BRICS Summit Fortaleza Declaration’ - see for example paragraphs 18 and 19 (BRICS 2014c).

[17] This will triple Japan’s infrastructure investment in ASEAN to US\$260bn. by 2020. A major vehicle for this expansion will be the Japan Overseas Infrastructure Investment

Corporation for Transport and Urban Development, which was established in October 2014 with a capital of US\$110bn. contributed by both the public and private sectors.

[18] The capital of ADB to be increased from US\$33bn. to US\$50bn. and annual lending capacity from US\$12bn. to US\$15bn.

[19] Japan and the USA have respectively 15.7% and 15.6% of the votes, while China has 6.4%, India 6.4% and Australia 5.8%. It is reported that China considers that its ADB vote share does not reflect its international role – the same view that it takes of its position in the World Bank (Lee 2014).

[20] In this context a critical issue is the already large, and very rapidly expanding Chinese investment in infrastructure within Asia as a whole (Ashi Simbum 2014; Page 2014).

[21] This dates from a sharp change in IMF policy during 2000 in the direction of openly supporting the establishment of formal regional monetary funds, but only as long as they did not compete with the Fund (see Bird and Rajan 2002: 39; Kohler 2001; Park 2001: 6). For the IMF the bottom line was, in the event of any application for financial assistance, a regional fund would defer to the IMF which would direct any macroeconomic policy that it deemed necessary.

[22] This fund, which covers the ASEAN+3 group of economies, has been expanded from an initial US\$90bn. to US\$500bn. For an account of the CMIM see: Dixon (2011); Grimes (2011).

[23] A series of monitoring and coordinating bodies have been established, most significantly, AMRO (ASEAN+3 Macroeconomic

Research Organisation), which has a permanent secretariat based in Singapore.

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